

Audit

Report



REVISED DOD PROGRESS PAYMENT PRACTICES

Report No. D-2001-188

September 27, 2001

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Acronyms

ACO	Administrative Contracting Officer
ACRN	Accounting Classification Reference Number
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DFAS	Defense Finance and Accounting Service
MOCAS	Mechanization of Contract Administration Services
PCO	Procuring Contracting Officer



INSPECTOR GENERAL
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September 27, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
UNDER SECRETARY OF DEFENSE (ACQUISITION,
TECHNOLOGY, AND LOGISTICS)
DIRECTOR, DEFENSE CONTRACT MANAGEMENT
AGENCY
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Audit Report on Revised DoD Progress Payment Practices
(Report No. D2001-188)

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Therefore, we request that the Director, Defense Contract Management Agency, provide additional comments to Recommendations A.2.c., A.2.d., and B.1.a. The Director, Defense Finance and Accounting Service did not provide comments to the Draft Recommendation B.2. We request management provide the requested comments by October 29, 2001.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. James L. Kornides at (614) 751-1400, extension 211 (jkornides@dodig.osd.mil) or Mr. Stuart D. Dunnett at (614) 751-1400, extension 214 (sdunnett@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

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Office of the Inspector General, DoD

Report No. D-2001-188

(Project No. D2000FJ-0261)

September 27, 2001

Revised DoD Progress Payment Practices

Executive Summary

Introduction. Progress payments are a type of contract financing that DoD routinely uses to purchase weapon system items that have long production lead-times. Periodic payments are made to contractors based on either the contractor's progress or on the basis of the cost incurred before the item is delivered to DoD. Military Department weapon system contracts and other contracts with progress payment clauses are maintained in the Mechanization of Contract Administration Services (MOCAS) system at the Defense Finance and Accounting Service (DFAS) Columbus. MOCAS maintained information on 321,946 contracts with obligations of \$846 billion as of January 31, 2001. DFAS Columbus disbursed approximately \$9.8 billion in progress payments on all contracts during FY 2000.

Objectives. The objective of the audit was to determine whether a revised 1998 DoD progress payment policy was adequately implemented. We expanded our review to determine whether contracting officers were providing payment instructions required by Defense Federal Acquisition Regulation Supplement 204.7107. We also reviewed the management control program as it related to the revised DoD progress payment policy.

Results. The progress payment policy established by the Under Secretary of Defense (Comptroller) in August 1998 and the Defense Federal Acquisition Regulation Supplement policy for payment instructions were not adequately implemented for 82 fixed-price contracts with multiple appropriations. Specifically, for six of the nine contracts that met the Comptroller criteria for payment instructions, Defense Contract Management Agency administrative contracting officers did not provide payment instructions to DFAS. In addition, for 76 of 138 contracts that met the Defense Federal Acquisition Regulation Supplement criteria for payment instructions, contracting officers did not include the required instructions. As a result, for the 82 fixed-price contracts with estimated total progress payments of \$915.6 million, progress payments will not be distributed to appropriations based on the best estimates of the specific work performed under the contract using available information (finding A).

DFAS did not follow the payment instructions on 20 of 63 progress payments on the 7 contracts with payment instructions provided by contracting officers. As a result, approximately \$39.7 million in progress payment disbursements related to the seven contracts were either inappropriately prorated from multiple appropriations or paid using a different payment methodology from those specifically directed by contracting officers. Replacing MOCAS with the Defense Procurement Payment System over the

next several years will not eliminate the problem because manual payments by DFAS will still be needed to pay according to the instructions provided (finding B).

Summary of Recommendations. We recommend the Under Secretary of Defense (Acquisition, Technology, and Logistics), direct contracting officers to comply with Defense Federal Acquisition Regulation Supplement 204.7107 (e)(3) for multiple appropriation progress payment contracts. We recommend that the Director, Defense Contract Management Agency, direct administrative contracting officers to provide required payment instructions to DFAS, monitor DFAS payments when instructions are provided, and establish a system and performance metric that tracks information on all progress payments contracts that require instructions. We also recommend the Director, Defense Contract Management Agency, identify to DFAS, all progress payment contracts that include payment instructions and verify that the payment instructions have been entered into MOCAS correctly. We recommend that the Director, DFAS, verify that contracts with payment instructions for progress payments are paid based on provided payment instructions

Management Comments. The Director, Defense Procurement agreed to issue guidance to contracting officers addressing the requirement to include payment instructions that meet the requirements of Defense Federal Acquisition Regulation Supplement 204.7107 (e)(3). The Director, Defense Contract Management Agency, agreed to direct administrative contracting officers to provide required payment instructions and to verify that the payment instructions have been entered into MOCAS correctly. The Director, Defense Contract Management Agency, did not agree to require administrative contracting officers to monitor DFAS payments when instructions are provided, to establish a system and performance metric that tracks all progress payment contracts that require instructions, or to identify to DFAS all progress payment contracts that included payment instructions. The Director, DFAS did not provide management comments. See the Finding sections of the report for details on the management comments and the Management Comments section for the complete text of management comments.

Audit Response. Comments from the Under Secretary of Defense (Acquisition, Technology, and Logistics) and the Director, Defense Contract Management Agency, were generally responsive. However, we disagree with the Director, Defense Contract Management Agency, comments regarding DFAS, establishing a tracking metric, and identifying contracts with progress payment instructions. While we agree that making progress payments is a DFAS responsibility, making manual progress payments results in an increased risk of error and therefore additional monitoring is warranted. The controls over identifying and monitoring progress payments by Defense Contract Management Agency were not adequate and additional oversight is needed. Also, the Administrative Contracting Officers have the best visibility over contracts that may require progress payment distribution instructions and providing this information to DFAS with only a minimal amount of effort. We request the Director, Defense Contract Management Agency and the Director, DFAS, provide comments to the final report by October 29, 2001.

Background

DoD routinely awards contracts to Defense contractors for weapon system items which have long production lead-times. Frequently, these contracts include financing clauses, where the Government makes periodic payments to the contractor based on either the contractor's progress or on the basis of the contractor's cost incurred before the contract item is delivered to the Government. It is considered to be more advantageous for the Government to finance the contractor than it is for the contractor to obtain commercial financing. Progress payments are one type of contract financing the Government commonly uses. Generally, contractors may submit progress payment requests monthly. The customary progress payment reimbursement rate on DoD contracts is 75 percent of the contract amount.

Progress Payment Administration. Military Department weapon system contracts with progress payment clauses are maintained in the Mechanization of Contract Administration Services (MOCAS) system at the Defense Finance and Accounting Service (DFAS) Columbus. The MOCAS system receives progress payment requests electronically from contractors. The system automatically processes the payment requests except when there are differences between the progress payment request and contract information, or specific payment instructions are either included in the contract or otherwise provided to DFAS. The MOCAS automatic payment process (proration) allocates progress payments to all accounting classification reference numbers (ACRNs) based on a weighted average of the contract line item amounts obligated in the contract. The ACRN contains accounting information such as the year and type of appropriation to be used. When progress payments include special payment instructions, the payment must be processed manually.

Matching Costs with Appropriations. In July 1997, the Under Secretary of Defense (Comptroller) expressed concerns that an attempt to match contractor costs with the appropriations corresponding to the type of work accomplished was frequently not performed. Using appropriations as intended, unless otherwise provided by law, is a basic requirement of section 1301(a), title 31, United States Code. Accordingly, the Under Secretary of Defense (Comptroller) directed a change in DoD policy that recognized the MOCAS proration methodology may not always fairly represent the work progress actually made by the contractor.

Initial Progress Payment Policy Change. On July 23, 1997, the Under Secretary of Defense (Comptroller) issued a memorandum to the Director of Defense Procurement, stating that progress payment distributions should be based on the best estimation of the specific work being performed under the contract using available information rather than the customary proration of payments across all available lines of accounting. The policy required that paying offices are provided payment distribution instructions on all progress payment requests when there were multiple appropriations on the contract.

Final Progress Payment Policy. In September 1997, the Director, DFAS, stated that there were administrative difficulties in implementing the July 23, 1997, policy memorandum on all progress payment contracts. After extensive discussions with DoD accounting, acquisition, and contract administration officials, the Under Secretary of Defense (Comptroller) issued a policy memorandum on August 7, 1998, that directed DoD to allocate progress payments on all new contracts issued after August 31, 1998, except firm-fixed-price contracts, on the basis of the best estimates of the specific work being performed under the contract using available information. Fixed-price (other than firm-fixed-price) contracts include fixed-price redetermination, fixed-price with economic price adjustment, and fixed-price incentive contracts.

Implementation of Revised Policy. Defense Contract Management Agency (DCMA) issued implementing policy for progress payment distribution through DCMA Directive 1, which is called the "One Book." The One Book required that the Administrative Contracting Officer (ACO) provide payment instructions to DFAS on all fixed-price (other than firm-fixed-price) progress payment contracts that have multiple appropriations. The payment instructions should have allowed DFAS personnel to determine the disbursement amounts for each applicable ACRN funding the contract line item. The DCMA policy did not permit the ACO to ask the contractor for a breakdown of costs at the ACRN level unless it was required in the contract. This policy applied to contracts awarded after October 1, 1998.

Defense Federal Acquisition Regulation Supplement. The Defense Federal Acquisition Regulation Supplement (DFARS) 204.7107 (e)(3), August 17, 1998, requires the contracting officer to provide payment instructions to DFAS in certain instances. The DFARS policy is applicable to all payments on a contract, including progress payments and does not exclude firm-fixed-price contracts from the requirement.

Fixed-Price Contracts. Contractors are allotted different types of fixed-price contracts and their use depends on the service or deliverable item needed by DoD. There are different types of fixed-price contracts including fixed-price redetermination, fixed-price with economic price adjustment, fixed-price incentive, and firm-fixed-price. Firm-fixed-price contracts are the only type of fixed-price contract that specifically cannot be adjusted for cost reasons. The remaining types of fixed-price contracts allow the contract price to be adjusted for reasons such as cost incentive programs or economic reasons.

Objectives

The objective of the audit was to determine whether a revised DoD progress payment policy was adequately implemented. We expanded our review to determine whether contracting officers were providing payment instructions required by Defense Federal Acquisition Regulation Supplement 204.7107 on firm-fixed-price progress payment contracts. We also reviewed the management control program as it related to the revised DoD progress payment policy. See Appendix A for a discussion of the scope, methodology, and management control program as they related to the audit objectives.

A. Implementation of Payment Instruction Requirements

The progress payment policy originally established by the Under Secretary of Defense (Comptroller) in August 1998 and DFARS 204.7107 (e)(3) were not adequately implemented for 82 of 190 contracts (valued at \$5.9 billion) issued between October 1, 1998, and August 31, 2000.

Specifically, for six of the nine contracts that met the Comptroller criteria for payment instructions, DCMA ACOs did not provide payment instructions to DFAS. In addition, for 76 of 138 contracts that met the DFARS criteria for payment instructions, contracting officers did not include the required instructions. These conditions occurred because:

- ACOs did not comply with the DCMA One Book or did not adequately monitor progress payment disbursements by DFAS, and
- PCOs were either unaware of the DFARS policy or did not believe that it applied to all disbursements for progress payments.

As a result, for the 6 fixed-price (other than firm-fixed-price) and 76 firm-fixed-price contracts with estimated total progress payments of \$915.6 million, progress payments will not be distributed to appropriations based on the best estimates of the specific work being performed under the contract using available information.

Progress Payment Disbursement Practices

Revised Progress Practices. On July 23, 1997, the Office of the Under Secretary of Defense (Comptroller) issued policy memorandum "Revised Progress Practices," requiring that all progress payment distributions be based on best estimates of the specific work being performed under the contract using available information. Initially, on October 1, 1997, DoD personnel should begin distributing all progress payments to the obligations that fund the costs incurred during the period covered by each progress payment request.

However, the July 23, 1997, policy memorandum was superseded by an August 7, 1998, policy memorandum titled "Progress Payment Distribution." In this policy memorandum, the Under Secretary of Defense (Comptroller) directed that contracts (other than firm-fixed-price) with multiple types of funds required payment instructions because those contracts were subject to risk of improper allocation and disbursement of funds. The firm-fixed-price contracts were excluded because they are not normally subject to price changes or cost saving incentives and over the life of the contract, funds will be used up according to the costs incurred by the contractor.

Defense Federal Acquisition Regulation Supplement Requirements. In addition to the revised progress payment policies announced by the Under Secretary of Defense (Comptroller), the DFARS provides complimentary

requirements for progress payment distribution instructions. Specifically, DFARS 204.7107 (e)(3) requires payment instructions for payments to contractors on progress payment contracts when contract items are funded by multiple ACRNs. For these contracts, DFARS 204.7107 (e)(3) requires that payment instructions provide a methodology for the paying office to assign payments to the appropriate ACRN, based on anticipated contract work performance. This policy applies to all types of payments, including progress payments.

Compliance with Revised Progress Payment Practices and DFARS Requirements

The progress payment policy established by the Under Secretary of Defense (Comptroller) in August 1998, as amended, was not adequately implemented. In addition, the DFARS policy was not adequately implemented for contracts with progress payment clauses.

Identifying Contracts Subject to Revised Comptroller Policy. To identify all contracts subject to the Comptroller and DFARS criteria for payment instructions, we obtained a MOCAS database extract of contracts issued from October 1, 1998, through August 31, 2000. Using the MOCAS extract, we identified 1,024 contracts authorizing progress payments valued at \$9.9 billion. Of those 1,024 contracts, 190 contracts valued at \$5.4 billion were fixed-price contracts with multiple appropriations that authorized progress payments. Table 1 lists the progress payment contacts identified and those that are subject to the revised Comptroller policy.

Table 1. Identifying Contracts Subject to Revised Comptroller Policy

<u>Contract Population</u>	<u>Number of Contracts</u>
Contracts Authorizing Progress Payments	1,024
Fixed-price Contracts with Multiple Appropriations	190
Contracts Subject to Revised Comptroller Policy	9
Contracts Where DCMA ACOs Did Not Comply with Policy	6

The MOCAS database showed that, of the 190 progress payment contracts, 6 contracts totaling \$456 million were fixed-price (other than firm-fixed-price), with multiple appropriations. ACOs were required to provide payment instructions to DFAS for those six contracts in accordance with the

July 23, 1997, Under Secretary of Defense (Comptroller) policy, as amended on August 7, 1998.

In addition to the six progress payment contracts identified in the MOCAS database, during fieldwork at DCMA field offices we identified three additional fixed-price (other than firm-fixed-price) contracts valued at \$101.1 million that also required payment instructions for DFAS. Two of the three contracts were not identifiable in our MOCAS database extract because the system could not identify more than one type of funding per contract and had identified the two contracts as firm-fixed-price contracts. The other contract was not identified in our universe of 190 contracts because MOCAS did not identify it as allowing progress payments. As a result, we determined that nine multiple appropriation progress payment contracts in MOCAS met the Comptroller policy. The nine fixed-price (other than firm-fixed-price) contracts were valued at \$557.6 million. For six of nine contracts that met the Comptroller criteria for payment instructions, DCMA ACOs did not provide payment instructions to DFAS.

Identifying Contracts Subject to DFARS 204.7107 (e)(3). The MOCAS data we reviewed showed that there were 182 firm-fixed-price multiple appropriation progress payment contracts. We reviewed 161 of the 182 firm-fixed-price multiple appropriation contracts to determine whether payment instructions were required in accordance with DFARS 204.7107 (e)(3). The remaining 21 contracts were not readily available for our review. Of the 161 contracts, 138 contracts valued at \$3.5 billion met the requirement for payment instructions. Table 2 lists the contracts identified that are subject to the DFARS requirements.

Table 2. Identifying Contracts Subject to DFARS Requirements

<u>Contract Population</u>	<u>Number of Contracts</u>
Contracts Authorizing Progress Payments	1,024
Firm Fixed-price Contracts with Multiple Appropriations	182
Contracts Not Available for Review	21
Contracts Not Subject to DFARS Requirement	23
Contracts Subject to DFARS Requirement	138
Contracts Where PCOs Did Not Comply with Requirement	76

Of these 138 contracts, the procuring contracting officer (PCO) did not include the required payment instructions on 76 contracts (55 percent) valued at

\$899 million. For the other 62 contracts, contracting officers provided payment instructions to DFAS.

Providing Payment Instructions to DFAS

Providing and Monitoring Payment Instruction by ACOs. For the six fixed-price (other than firm-fixed-price) contracts, payment instructions were not provided to DFAS because ACOs did not follow the DCMA One Book policy. In addition, ACOs were not always monitoring whether DFAS paid progress payments according to their specific payment instructions.

Following DCMA Policy. The DCMA One Book, chapter 9, requires ACOs to provide DFAS written payment instructions for progress payments at the ACRN level for multiple appropriation fixed-price (other than firm-fixed-price) contracts. Although five of the six ACOs responsible for the nine sample contracts were aware of the DCMA One Book requirements, only three of the nine contracts included payment instructions for DFAS disbursement personnel to follow. The three ACOs stated that MOCAS proration may have been valid for the six contracts but they did not provide DFAS with instructions to prorate the progress payment. The ACOs were required to provide payment instructions to DFAS even when they determined that proration is the best method.

Monitoring DFAS Payments. When the instructions were provided, the ACOs were not always monitoring whether DFAS properly paid progress payments in accordance with the payment instructions provided. Instead of following the payment instructions on these contracts, DFAS either prorated the progress payments or made a manual payment using a methodology that differed from what the ACO instructed. However, only one of three ACOs responsible for the contracts contacted DFAS to question the payments and make corrections. The two ACOs who did not monitor the DFAS payments subsequently planned to contact DFAS and make corrections after we identified that DFAS was prorating the progress payments.

We believe that additional guidance is needed because chapter 9 of the DCMA One Book does not specifically require ACOs to monitor whether DFAS follows their progress payment instructions. A process for ACOs to monitor whether DFAS pays according to instructions would ensure that DFAS is aware of contracts that include instructions and that the instructions are followed.

PCO Payment Instructions. Payment instructions on firm-fixed-price contracts were not provided to DFAS because PCOs were either unaware of the DFARS policy or did not apply it to all progress payment contracts. Only 62 of the 138 contracts we reviewed included payment instructions for DFAS. We contacted 8 PCOs responsible for 8 of the 76 contracts that did not include payment instructions but should have. Seven of the eight PCOs that we spoke with stated that they were not specifically aware of the payment instruction requirements of DFARS 204.7107(e)(3). One PCO that we spoke with was aware of the DFARS clause but did not believe that it was applicable to the sample contract because the PCO did not believe that the contractor would be

requesting progress payments. However, we determined that the contract contained multiple appropriations, met the requirements of DFARS 204.7107(e)(3), and progress payments were made by DFAS for this contract. Therefore, this contract should have included payment instructions.

We also contacted three PCOs responsible for contracts that included payment instructions. We determined that none of the three PCOs included the payment instructions to comply with DFARS 204.7107(e)(3). The PCOs stated that payment instructions were included as a normal business practice or as an administrative convenience, such as "pay oldest funds first," and not as an attempt to match contractor costs with DoD funds.

The intent of the policy is to ensure that progress payment distributions are based on the best estimation of the specific work being performed under the contract rather than the customary proration of payments across all available lines of accounting. In most instances, progress payments on the 76 firm-fixed-price contracts without instructions were and will continue to be prorated without any attempt to properly match the contractor costs or progress to the DoD appropriations financing the contract. Therefore, the intent of DFARS 204.7107(e)(3) was not met for these contracts.

Matching Costs and Progress Payments

The objective of the revised progress payment practices and the DFARS policy was not achieved. The policies were established to ensure that progress payments would be based on the actual work performed or costs incurred during the period covered by the payment request. However, payment instructions for estimated progress payments on 6 fixed-price (other than firm-fixed-price) contracts (valued at \$241.3 million) and 76 firm-fixed-price contracts (valued at \$674.3 million) that met the DFARS criteria for payment instructions were not provided so that work performed or costs incurred could be matched to the DoD appropriations funding the contract. The objective was not achieved because progress payments were made from all appropriations funding the contract item regardless of the type of work performed by the contractor.

In July 1997, the Under Secretary of Defense (Comptroller) expressed concerns that an attempt to match contractor costs with the appropriations corresponding to the type of work accomplished was frequently not being performed. The intent of DFARS 204.7107 (e)(3) is to pay contractors in a manner that reflects the performance of work being done on the contract. In addition, using appropriations only as intended is a basic requirement of 31 U.S.C. 1301(a). The Code requires that appropriations be applied only to the items for which they were intended, unless otherwise provided by law. Accordingly, the Under Secretary of Defense (Comptroller) directed a change in DoD policy that recognized the MOCAS proration methodology, which is based on the weighted average of obligated dollars, may not always fairly represent the work progress actually made by the contractor.

Matching Appropriations and Contractor Performance. During the audit, we identified an example in which the progress payments did not match the

work performed by the contractor. Specifically, on Contract No. F33657-99-D-0028 for the Air Force B-2 aircraft program, two delivery orders were placed that were valued at \$40.4 million and were intended for labor needed for product support. Product support is recurring labor that is required to support the B-2 post-production program and is not clearly identifiable to an end product. Product support includes recurring effort associated with Configuration Management, Data Management, Change Management, Test Operations (Planning Only), and Administration. The contractor was paid a total of \$3.5 million in six progress payments. The delivery orders contain multiple ACRNs and include Research, Development, Test and Evaluation; Operation and Maintenance; and Procurement appropriations.

The ACO provided us the contractor's supporting cost data for the progress payments. The cost data indicated that all of the costs incurred by the contractor were engineering, overhead, and data processing. Therefore, prorating the progress payments to all available appropriations would not have been appropriate for these progress payments. For those payments, the type of work performed by the contractor is depot maintenance related activities. Depot maintenance work is normally funded through Operations and Maintenance appropriations and not Research and Development or Procurement funds.

Payment instructions were not written for this contract although they were required as a result of the revised progress payment policy memorandums and the DCMA One Book requirements. Written payment instructions would have prevented the potential mismatch between the use of appropriations and work performed by the DoD contractor because an attempt to match the proper funds with the work performed over a specific period of time would have been made.

Management Comments on the Finding

DCMA Comments. The Deputy Director, DCMA, partially concurred with the finding and stated that the One Book will be revised to specify that the ACO will document which progress payment distribution method is appropriate, including proration. In addition, the Deputy Director stated that a training package is in development that will provide ACOs with the necessary information to determine when payment instructions are required and the appropriate method for developing them and providing them to DFAS.

Recommendations, Management Comments, and Audit Response

A.1. We recommend that the Under Secretary of Defense (Acquisition, Technology, and Logistics) direct contracting officers to include payment instructions in Section G of contracts that meet the requirements of Defense Federal Acquisition Regulation Supplement 204.7107 (e)(3), including the 76 contracts identified by the audit shown in Appendix B.

Management Comments. The Office of the Under Secretary of Defense (Acquisition Technology & Logistics) concurred with the recommendation and stated that the Director, Defense Procurement, will send a memorandum within 60 days of issuance of the final report to the DoD contracting community addressing the importance of providing payment instructions that fulfill the DFARS 204.7107 (e)(3) requirements. Specifically, the memorandum will require that instructions be provided for the 76 contracts identified in Appendix B, as well as for any additional contracts that meet the criteria identified in DFAS 204.7107 (e)(3). In addition, the Defense Procurement Home Page will post an information item identifying this subject as a topic requiring the attention of the DoD contracting community.

A.2. We recommend that the Director, Defense Contract Management Agency:

- a. Direct administrative contracting officers to provide payment instructions to the Defense Finance and Accounting Service on all contracts meeting the requirements of the revised Comptroller progress payment policy.

Management Comments. The Deputy Director partially concurred and stated that ACOs will be directed to comply with Chapter 9 of the One Book and with planned revisions to the One Book.

- b. Initiate action to develop payment instructions for the 76 firm-fixed-price contracts identified by the audit shown in Appendix B.

Management Comments. The Deputy Director, DCMA, concurred and stated that PCOs will be notified that payment instructions must be provided in accordance with DFARS 204.7107(e)(3).

- c. Revise Defense Contract Management Agency Directive 1, the One Book, to include a requirement that administrative contracting officers monitor whether the Defense Finance and Accounting Service pays progress payments according to the payment instructions provided.

Management Comments. The Deputy Director, DCMA, nonconcurred and stated that although providing progress payment distribution instructions is an ACO responsibility, it is the responsibility of DFAS to apply those instructions when making progress payments. The Deputy Director did not believe that it would be appropriate for DCMA to act in such an oversight role.

Audit Response. We consider the Deputy Director's comment to be nonresponsive. While we agree that making progress payments is a DFAS responsibility, manual progress payment disbursements have an increased risk of error and therefore additional controls over accuracy are warranted. In addition, relatively few DCMA administered contracts include progress payment instructions. We do not consider the oversight an undue burden on the ACO's and believe it is warranted. We request that the Deputy Director reconsider his comments and provide additional comments to the final report.

d. Establish a tracking system and performance metric that maintains updated information on all contracts that may require payment instructions, shows how many contracts include payment instructions, and shows whether the Defense Finance and Accounting Service makes payments according to the instructions.

Management Comments. The Deputy Director, DCMA, nonconcurred and stated that it would be inappropriate to establish a tracking system and performance metric for monitoring progress payment distribution instructions because:

- the number of contracts covered by the Under Secretary of Defense (Comptroller) revised progress payment policy is very small;
- since PCOs are responsible for complying with DFARS 204.7107(e)(3), it would not be an appropriate function for DCMA to monitor;
- monitoring the degree to which DFAS pays according to payment instructions is the responsibility of DFAS, and would not be an appropriate function for DCMA; and
- duplicating controls that should already be in place would not be cost effective.

Audit Response. We consider the Deputy Director's comments to be non-responsive. The DCMA controls over providing required payment instructions to DFAS, monitoring whether payment instructions were properly input into MOCAS, and monitoring whether DFAS followed the payment instructions, were not adequate. Therefore, additional oversight is needed. In addition, the progress payment contracts that require distribution instructions have not been fully identified and DCMA ACCOs are in the best position to monitor implementation of DoD policies that require progress payment distribution instructions. We request that the Deputy Director reconsider his comments and provide additional comments to the final report.

B. Following Progress Payment Instructions

For the three fixed-price (other than firm-fixed-price) and four firm-fixed-price contracts that contained payment instructions, DFAS did not always properly follow the payment instructions provided by the contracting officers. DFAS did not pay according to payment instructions for the seven contracts because the instructions were either not properly entered into MOCAS, not verified by the ACO, not followed, or MOCAS controls were not adequate. As a result, approximately \$39.7 million in progress payment disbursements related to the seven contracts were either inappropriately prorated from multiple appropriations or paid using a different payment methodology from those specifically directed by contracting officers.

DFAS Progress Payment Disbursement Process

Progress payments are automatically prorated by the MOCAS system unless the contracting officer provides written payment instructions either in section G, "Contract Administration Data" of the contract, in special MOCAS files, or other written forms. Written payment instructions are provided to prevent progress payments from being automatically prorated.

Progress payments that are prevented from being paid automatically are forwarded to a voucher examiner for manual payment. Payment instructions are input into MOCAS data elements that prevent the system from automatically prorating the payment. Those data elements include fields such as "Auditor Approval" and "Progress Payment Special Pay Instructions." When a voucher examiner receives the rejected progress payment because there are payment instructions, the voucher examiner is required to process the disbursement according to the payment instructions.

Identifying Contracts with Payment Instructions

Improvements in the progress payment process at DFAS Columbus were needed because DFAS did not adequately identify contracts with progress payment clauses that included special payment instructions provided by contracting officers. We identified three fixed-price (other than firm-fixed-price) and four firm-fixed-price contracts with progress payment clauses where either the ACO or PCO provided payment instructions to DFAS. We reviewed 63 progress payments made on those 7 contracts, and determined that DFAS did not follow the payment instructions on 20 of the progress payments. The 20 progress payments were for work performed on the 7 contracts with payment instructions. For the 43 progress payments in which DFAS paid properly, the instructions provided were primarily to use normal MOCAS proration or were not relevant because only 1 ACRN and appropriation had been assigned at that

stage of the contract. Therefore, for these progress payments, the chance of not following the payment instructions would be minimal.

Payment Instructions and MOCAS Controls

Payment instructions provided by ACOs and PCOs were not followed because DFAS Columbus personnel did not input the payment instructions accurately or promptly. ACOs did not verify that the MOCAS payment instructions had been entered, DFAS personnel did not always follow the payment instructions provided, and MOCAS controls for preventing automatic payments on contracts with instructions were not adequate. Twice, a DFAS employee incorrectly coded the payment instructions input into MOCAS. On two other occasions, the payment instructions were not entered into MOCAS. In addition, a modification was not input into MOCAS in a timely manner. DFAS personnel also mistakenly overlooked the payment instructions that were coded into MOCAS when manually paying the progress payments. In other instances, MOCAS did not alert payment personnel that payment instructions were included in MOCAS contract files. As a result of those weaknesses, payments were not made in accordance with the contracting officer's payment instructions.

Inputting Payment Instructions. Payment instructions were not followed because DFAS employees mistakenly coded the payment instructions input into MOCAS on two contracts. In one of the two contracts in which payment instructions were mistakenly coded, a DFAS employee input payment instructions into a field unrelated to progress payments instead of the "Progress Payment Special Pay Instructions" field. The "Progress Payment Special Pay Instructions" field is designed to stop any progress payment request from being paid automatically (prorated). The progress payments were not prorated because manual processing was required due to other reasons unrelated to payment instructions. Although the progress payments were paid manually, the voucher examiner was not aware of the payment instructions because they were not present in the proper field. The improper input of the payment instructions resulted in four progress payments (totaling \$24.5 million) not being paid according to the PCO instructions.

On another contract with payment instructions provided by the PCO, DFAS personnel mistakenly entered payment instructions into the "Special Pay Instruction" field instead of the "Progress Payment Special Pay Instructions" field. DFAS personnel were not aware that the instructions were for the distribution of progress payments because the wording was unclear. This mistake resulted in one progress payment totaling \$220,000 not being paid according to the intent of the PCO instructions.

In two other contracts with payment instructions provided by the PCO, DFAS personnel inadvertently did not enter the payment instructions into MOCAS. The instructions should have been entered into the "Progress Payment Special Pay Instructions" field. As a result of the error, five progress payments totaling \$4.4 million were inappropriately prorated instead of paid according to the PCO instructions.

Timing. Payment instructions were also not followed because a contract modification was not entered into MOCAS until 4 months after the effective date of the modification. The contract modification added a new appropriation and payment instructions to pay on the new appropriation before any other. Two progress payments totaling \$550,000 were paid after the effective date of the modification but prior to the input date. Therefore, the payment instructions provided by the PCO were not followed because the new appropriation was not used to pay the progress payment.

ACO Verification. Payment instructions were also not followed because ACOs did not verify that instructions were properly entered into MOCAS. The DCMA One Book requires the ACO to verify that any payment instructions the PCO has included in the contract have been entered into MOCAS. In all four contracts that had payment instructions written into the contract by the PCO, the ACO did not verify that the instructions had been entered into MOCAS accurately or timely. If the ACOs had verified that the payment instructions were entered into MOCAS, they would have discovered that the instructions were miscoded in two contracts and not entered at all in two others. They would have also discovered a modification with payment instructions was not entered until 4 months after the effective date it was issued.

Manual Progress Payments. Payment instructions were not followed because DFAS employees mistakenly overlooked progress payment instructions when making manual progress payments. On five progress payments totaling approximately \$3.0 million, MOCAS correctly rejected the progress payment for automatic payment. However, DFAS personnel did not follow the payment instructions for those progress payments. DFAS personnel either improperly paid from only one ACRN or prorated the disbursement using an incorrect percentage. When we asked DFAS disbursement personnel about this, they agreed that the payment instructions were simply not followed.

MOCAS Controls. Controls over progress payments with written payment instructions that were properly input into MOCAS needed improvement because DFAS disbursement employees were not always aware that payment instructions were provided and input into MOCAS. For example, in one contract in which payment instructions were entered into the ACO Notebook by the ACO, MOCAS controls did not prevent an automatic progress payment totaling \$4.0 million from occurring. The ACO Notebook provides a place in which ACOs can enter payment instructions for DFAS. The ACO who entered the instructions in the notebook believed that DFAS personnel always check the ACO Notebook before payment. However, DFAS personnel never see the ACO Notebook when progress payments are paid automatically and there is no MOCAS control to ensure that this field is in place.

On two other progress payments totaling \$3.0 million, payment instructions were entered on the progress payment invoice and possibly into the “Progress Payment Special Pay Instructions” field of MOCAS at the time of disbursement. However, MOCAS did not prevent the payments from being prorated so that the disbursements could be made in accordance with DoD policies. For those payments, the “Progress Payment Special Pay Instructions” field indicated that payment instructions were present at the time of our audit. However, we could

not determine whether the payment instructions were input after the two progress payments were inappropriately made because the date the field was coded was not available.

MOCAS is scheduled to be replaced by the Defense Procurement Payment System beginning in the summer of 2001. Because it is inadvisable to make a MOCAS system change, we questioned DFAS payment personnel about how to ensure that progress payments with instructions would be paid manually. DFAS employees stated that there is a field in MOCAS titled "Auditor Approval" that, when properly coded, will prevent an automatic payment on any invoice. DFAS disbursement personnel believed that if DCMA provided them a list of applicable contracts with payment instructions (other than proration) they could enter a code in the "Auditor Approval" field to prevent the progress payment from being automatically prorated. The code would require that the progress payment be paid manually by a voucher examiner.

We also contacted the program office for the Defense Procurement Payment System to determine how payment instructions for progress payments will be included in the new system. A representative in the program office stated that payment instructions on progress payments would have to be performed manually in the new system. The new system will have fields similar to MOCAS that are designed to trigger a manual payment when necessary.

Prorating Progress Payments

Twenty progress payments from the seven contracts valued at approximately \$39.7 million were either inappropriately prorated from multiple appropriations or paid using a different payment methodology from those specifically directed by contracting officers. Contracting officers include payment instructions in contracts so that contractor costs are matched with the appropriation that should fund the work progress and to prevent obligated funds from expiring before disbursement. Using appropriations only for their intended purpose is a basic requirement of 31 U.S.C. 1301(a). The Code requires that appropriations be applied only to the items for which they were intended, unless otherwise provided by law.

The Office of the Under Secretary of Defense (Comptroller) has expressed concerns that a reasonable attempt to match contractor costs with the proper appropriation may not always occur when progress payments are automatically prorated by MOCAS. For some high-dollar DoD contracts, when appropriations are not matched to costs, a risk exists that appropriations will be disbursed for contractor work unrelated to the intended use of the funds. Therefore, DoD policy requires that a reasonable attempt to match contractor cost with the proper DoD funds be performed on many complex contracts that authorize progress payments.

DFAS, in conjunction with DCMA, has been tasked to ensure that appropriations are used only for their intended purpose. The policy requirements of the DCMA One Book and DFARS 204.7107 are designed to prevent the actual or apparent misuse of appropriations by DoD when making

progress payments. DFAS was required to implement the payment instructions provided by contracting officers. For several contracts, DFAS erroneously entered payment instructions into MOCAS or made progress payments without following the instructions provided by a contracting officer. For other contracts, MOCAS did not alert payment personnel that payment instructions were present even though the payment instructions were entered into MOCAS properly. Therefore, improvements are needed so that progress payments are made in accordance with DoD and Federal requirements.

Management Comments on the Finding and Audit Response

Management Comments. The Deputy Director, DCMA, partially concurred and stated that payments were not made according to instructions because payment instructions were either not properly input into MOCAS or were not followed by the payment office. He did not concur that the lack of verification by the ACO that the payment instructions were input correctly was a direct cause of incorrect payments or that MOCAS controls are inadequate. He stated that the ACO plays a secondary role in verifying that payment instructions are input correctly and therefore not performing this function would only indirectly contribute to the payment office not following payment instructions. He further stated that DCMA will develop training that will reinforce payment instruction guidance and will investigate MOCAS control problems if evidence develops that a malfunction exists.

Audit Response. Although the Deputy Director partially concurred with the finding, we consider his comments to be fully responsive.

DCMA Comments. The Deputy Director nonconcurred that a material management control weakness exists with respect to verifying whether payment instructions have been input into MOCAS properly. The Deputy Director explained that DFAS has responsibility for paying according to payment instructions contained in the contract. He stated that DCMA will provide training to ACOs on the process for entering payment instructions and for verifying that payment instructions entered by DFAS are entered properly.

Audit Response. Although the Deputy Director nonconcurred that a material management control weakness existed, we consider his comments to be fully responsive and no further comments are required.

Recommendations, Management Comments, and Audit Response

B.1. We recommend that the Director, Defense Contract Management Agency:

- a. Identify all progress payment contracts that include payment instructions to the Defense Finance and Accounting Service Columbus.**

b. Direct administrative contracting officers to follow Defense Contract Management Agency “One Book” policy and verify the accuracy of instructions and that the “Progress Payment Special Pay Instructions” field in Mechanization of Contract Administration Services is properly coded, when instructions are present.

c. Direct responsible administrative contracting officers to coordinate with the Defense Finance and Accounting Service Columbus to review progress payments made for instances in which payment instructions were not followed and make the necessary corrections for the following seven contracts: F0470100C0500, F0470199C0047, F1962800C0023, F3365799C3045, F3365799G39000004, F3365799G39000024, and N0003099C0008.

Management Comments. The Deputy Director, DCMA, concurred with Recommendations B.1.b. and B.1.c. and stated that DCMA will direct ACOs to follow One Book policy and verify the accuracy of payment instructions. In addition, the Deputy Director stated that DCMA will direct the ACOs to properly code MOCAS when instructions are present and to coordinate with DFAS to make necessary corrections to the seven contracts. The Deputy Director nonconcurred with Recommendation B.1.a. to identify all contracts that include progress payment distribution instructions and stated that this function was a DFAS responsibility.

Audit Response. We consider the Deputy Director’s comments to Recommendation B.1.a. to be nonresponsive. ACOs have the best visibility over all contracts that may require progress payment distribution instructions and could provide this information to DFAS with a minimal amount of effort. In addition, ACOs are required by DCMA policy to verify that payment instructions have been input by DFAS correctly. Therefore, we believe ACOs should have the contract familiarity to perform this function. We request that the Deputy Director reconsider his comments and provide comments to the final report.

B.2. We recommend that the Director, Defense Finance and Accounting Service, make the necessary entries into Mechanization of Contract Administration Services and the Defense Procurement Payment System, as it is phased in, to ensure that contracts with payment instructions for progress payments are paid according to instructions provided.

Management Comments Required

The Director, DFAS, did not comment on a draft of this report. We request that the Director provide comments on the final report.

Appendix A. Audit Process

Scope and Methodology

Work Performed. We reviewed the revised progress payment practices policy and subsequent revisions announced by the Under Secretary of Defense during calendar years 1997 and 1998. On July 23, 1997, the Under Secretary of Defense issued a policy memorandum requiring that all progress payment distributions be based on the best estimate of the specific work being performed under the contract using available information. The policy was subsequently revised to exclude firm-fixed-price contracts and all contracts awarded prior to September 1, 1998. To test for compliance, DFAS Columbus provided a MOCAS database extract of contracts with financing payments that were awarded between October 1, 1998, and August 31, 2000. The database extract included fields for progress payments and contract type. Using the MOCAS extract, we identified 1,024 contracts authorizing progress payments valued at \$9.9 billion. Of those 1,024 contracts, 190 contracts valued at \$5.4 billion were fixed-price contracts with multiple appropriations that authorized progress payments.

From this universe of 190 contracts, we identified six fixed-price (other than firm-fixed-price) MOCAS contracts with multiple appropriations that required payment instructions for the payment office. We identified three additional progress payment contracts during audit fieldwork that also met the revised policy criteria. The total value of the portions of the nine contracts that were fixed-price contracts was \$557.6 million.

In addition, we reviewed 161 of the 182 firm-fixed-price multiple appropriation contracts identified in the MOCAS database for compliance with DFARS 204.7107 (e)(3). Of the 182 contracts, we were unable to determine whether 21 contracts fit the criteria of requiring payment instructions. Of the 161 contracts, we determined that 138 required payment instructions. Of the 138 contracts, 62 contained payment instructions and 76 did not. Out of the 62 contracts that had payment instructions, we reviewed 4 to determine whether DFAS paid in accordance with the instructions. For these 62 contracts, we did not test the adequacy of the payment instructions provided with respect to matching contractor costs with DoD funds at the time of disbursement. We examined the progress payment distribution instructions in the contracts and on progress payment invoices, questioned ACOs and PCOs about the rationale of the payment instructions and any potential positive or negative effects, and compared the payment instructions to the progress payment distributions by DFAS.

Limitations to Scope. The MOCAS system accepts only one contract type for each contract in the system even though there can be multiple contract types on

a single contract. For example, a contract can have cost, firm-fixed-price, and other than firm-fixed-price contracts on individual contract line items. As a result of this MOCAS system limitation, we could not verify the completeness of the different contract types identified in MOCAS as other than firm-fixed-price. Defense Procurement Payment System does not currently have any plans to record multiple contract types within a single contract. In addition, 21 of 182 firm-fixed-price contracts were not readily available for review. Therefore, we did not include any results from those contracts in our report.

DoD-Wide Corporate Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal and subordinate performance goal.

- **FY 2001 DoD Corporate-Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-02)**
- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. **(01-DoD-2.5)**

DoD Functional Area Reform Goal. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objective and goal.

- **Financial Management Area. Objective:** Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. **(FM-5.3)**

General Accounting Office High Risk Areas. The General Accounting Office has identified several high risk areas in the DoD. This report provides coverage of the Defense Contract Management and Defense Financial Management high-risk areas

Computer-Processed Data. We used a MOCAS contract database that contained all contracts awarded between October 1, 1998, and August 31, 2000, that DFAS defined as having financing provisions. We relied on the computer-processed data to determine our contract sample without performing tests of system general and application controls to confirm the reliability of the data. We also used Electronic Data Access and Electronic Data Management records to review the contract data. We did not establish reliability of the data because it would have required audit resources that are not available. However, not establishing the reliability of the computer-processed data did not materially affect the results of our audit because we reviewed paper copies or scanned images of contract information.

Audit Type, Date, and Standards. We performed this economy and efficiency audit from August 2000 through May 2001 in accordance with generally accepted Government auditing standards except that we were unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD. Further details are available on request.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40 "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We reviewed DCMA and DFAS management's self-evaluation of controls over the administration and disbursement of progress payments requiring distribution instructions.

Adequacy of Management Controls. We identified material management control weaknesses for DoD, as defined in DoD Instruction 5010.40. DCMA management controls were not adequate to ensure that progress payment instructions were provided or monitored when required. DFAS management controls were not adequate to ensure that progress payment instructions were followed when making progress payments. Recommendations A.1., A.2., B.1., and B.2., if implemented, will correct the weaknesses. A copy of the report will be provided to the senior official within DCMA and DFAS responsible for management controls.

Adequacy of Management's Self Evaluation. Management's self-evaluation was not adequate. DCMA and DFAS identified contract payments as assessable units; however, they did not report the material management control weaknesses identified during the audit.

DCMA Comments. The Deputy Director nonconcurred that the findings represent a material management control weakness. The Deputy Director stated that DCMA has policies in place to manage preparation of distribution instructions for progress payment contracts and for monitoring input of the instructions into MOCAS. He stated that DCMA has a process in place to apply those policies and also has an oversight process to reinforce their application. He reiterated that the One Book will be clarified concerning progress payment instructions and that a training package for ACOs will also be developed.

Audit Response. The Deputy Director's comments to the recommendations should correct the materiel management control weakness.

Prior Coverage

The General Accounting Office, and the Inspector General, DoD, have conducted multiple reviews related to contract payments.

General Accounting Office reports can be accessed on the Internet at
<http://www.gao.gov>.

Inspector General, DoD, reports can be accessed on the Internet at
<http://www.dodig.osd.mil/audit/reports>.

Appendix B. Firm-Fixed-Price Contracts Requiring Payment Instructions by DFARS 204.7107

Army - 28 Contracts

DAAA0900C0010
DAAA0999C0020
DAAA0999C0025
DAAA0999C0040
DAAA0999C0066
DAAA0999C0067
DAAA0999D00120001
DAAA0999D00120010
DAAB0799CD285
DAAB0799CH004
DAAB0799CJ558
DAAB0799CJ559
DAAB0799DB6050001
DAAB0799DD7700001
DAAE0700CM004
DAAE0799CN049
DAAE0799CT046
DAAE0799DT0460001
DAAE2000D00240001
DAAH0100C0033
DAAH0100C0039
DAAH0100C0044
DAAH0199C0031
DAAH0199C0050
DAAH0199C0126
DAAH0199C0171
DAAH2300C0048
DAAH2399C0238

Air Force - 23 Contracts

F0863099C0071
F0863099C0092
F0863599C0028
F0960300C0160
F0960399C0076
F0960399C0154
F0960399D02580001
F0960499C0123
F1962899D06050001
F3365799G30390001
F3365799G30520001
F4160800C0068
F4160899C0378
F4160899C0521
F4160899D05830001
F4162400D11050001
F4261099C0015
F4262099C0083
F4262099C0102
F4263099C0162
F4263099C0185
F4263099C0203
F4263099C0256

Navy - 25 Contracts

N0001999D10160001
N0002400C5141
N0002400C5223
N0002499C4046
N0002499C5214
N0010400CK002
N0010400CK017
N0010400CK037
N0010400CK076
N0010400CK086
N0010499CK009
N0010499CK010
N0010499CK020
N0010499CK092
N0010499CK101
N0010499CK102
N0010499CK106
N0010499CK120
N0016400D00100001
N0016499C0012
N0016499C0027
N0016499D00230002
N0016499D00290003
N0017899C1027
N0038399CD016

Appendix C. Firm-Fixed-Price Contracts With Payment Instructions

Army - 1 Contract	Air Force - 36 Contracts	Navy - 25 Contracts
DAAE0799CM011	F0470100C0500 F0470100C0501 F0470199C0047 F0470199C0048 F0862699C0248 F0862699C0251 F0863000C0009 F0863099C0010 F0863099C0011 F0863099C0012 F0863099C0016 F0863099C0018 F0863099C0020 F0863099C0052 F0863099C0088 F0863500C0032 F0863599C0001 F0863599C0035 F0863599C0056 F0863599C0118 F0960399C0153 F0960399D02580002 F1962899C0024 F1962899C0036 F2960199C0167 F3060299C0011 F3361599C3202 F3365799C2040 F3365799C3056 F3365799D20410001 F3365799G39000004 F3365799G39000024 F3460199C0096 F4160899C0183 F4160899C0367 F4262099C0116	N0001900C0268 N0001999C1014 N0001999C1051 N0001999C1054 N0001999C1090 N0001999C1131 N0001999C1274 N0001999C1331 N0001999C1561 N0002499C4059 N0002499C5116 N0002499C5373 N0002499C5374 N0002499C5377 N0003000C0016 N0003900D21000001 N0003900D21010001 N0016499D00080004 N6133999C0084 N6339400C4001 N6523699C5038 N6660499C0373 N6660499C1187 N6833599C0007 N6833599C0167

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
 Director, Defense Procurement
Under Secretary of Defense (Comptroller)
 Deputy Chief Financial Officer
 Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

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Under Secretary of Defense (Acquisition, Technology, and Logistics) Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

AUGUST 24, 2001

DP/CPF

MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE
ATTN: DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE

THRU: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *MS/EP/201*

SUBJECT: Draft of a Proposed OIG Report, 'Revised DoD Progress Payment Practices,' dated July 2, 2001, Project No. D2000FJ-0261

Your memorandum of July 2, 2001, requested comments on the subject draft report. The draft report's objective was to evaluate compliance with revised 1998 DoD Progress Payment policies directing DoD contracting and disbursing offices to distribute progress payments on all contracts, except firm-fixed price contracts, on the basis of best estimates of the specific work being performed on the contract, using available information. The audit also reviewed whether contracting officers are providing payment instructions required by the Defense Federal Acquisition Regulation Supplement (DFARS) 204.7107. Instructions are required for contract line items (CLIN) funded by more than one accounting classification reference number (ACRN).

The draft report asserts that these policies were not adequately implemented. In addition, the report found that, even when payment instructions were provided, they were, for the most part, not followed by disbursing officials. The draft report attributes these findings to a lack of familiarity with the policy requirements on the part of DoD contracting and disbursing officials.

We agree with the draft report recommendation that the Under Secretary of Defense (Acquisition, Technology, and Logistics) direct contracting officers to comply with DFARS 204.7107(e)(3) requirements that payment instructions be provided for contract line items that are funded with multiple appropriations represented by multiple ACRNs. Detailed comments on the draft report are attached.



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DOD IG Draft Report
July 2, 2001

"Revised DoD Progress Payment Practices "

REPORT NO. D2000FJ-0261

COMMENTS OF THE OFFICE OF THE UNDER SECRETARY OF DEFENSE
(ACQUISITION, TECHNOLOGY, AND LOGISTICS)

* * * * *

RECOMMENDATION A1.: We recommend that the Under Secretary of Defense (Acquisition, Technology, and Logistics) direct contracting officers to include payment instructions in Section G of contracts that meet the requirements of Defense Federal Acquisition Regulation Supplement 204.7107(e)(3), including the 76 contracts identified by the audit shown in Appendix B.

DOD RESPONSE:

Concur. Within 60 days of the issuance of this draft report as a final report, the Director, Defense Procurement will send a memorandum to the DoD contracting community addressing the importance of providing payment instructions that fulfill the requirements of DFARS 204.7107(e)(3). The memorandum will specifically request that instructions be provided for the 76 contracts identified in Appendix B of the draft report, as well as for any additional contracts that meet the criteria identified in DFARS 204.7107(e)(3). In addition, the Defense Procurement Homepage will post an information item identifying this subject as a topic requiring the attention of the DoD contracting community.

Defense Contract Management Agency Comments



DEFENSE CONTRACT MANAGEMENT AGENCY
6350 WALKER LANE, SUITE 300
ALEXANDRIA, VIRGINIA 22310-3226

SEP 4 2001

IN REPLY
REFER TO

DCMA-OCB

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL
ATTN: Director, Finance and Accounting Directorate

SUBJECT: DoDIG Draft Report, Project No. D2000FJ-0261,
Revised DoD Progress Payment Practices

This is in response to the Department of Defense Inspector General memorandum of July 2, 2001, subject as above. The Defense Contract Management Agency comments to the draft audit report are attached. Please refer any questions you may have to Mr. Timothy Frank, email: tfrank@hq.dcmna.mil, telephone (703) 428-1005.

A handwritten signature in black ink, appearing to read "Thomas E. Brunk".

THOMAS E. BRUNK
Deputy Director

Attachment

SUBJECT: DoDIG Draft Report, Project No. D2000FJ-0261,
Revised DoD Progress Payment Practices

Executive Summary

DCMA Comments on the Executive Summary.

Introduction. The third paragraph, first sentence states: "To ensure the proper control of funds, the Under Secretary of Defense (Comptroller) (USD(C)) issued a policy memorandum titled "Progress Payment Distribution" in August 1998 that directed DoD contracting and disbursing offices to distribute progress payments on all contracts, except firm-fixed price contracts, on the basis of the best estimates of the specific work being performed under the contract using available information." We recommend that this sentence be revised to read: "To ensure the proper control of funds, the Under Secretary of Defense (Comptroller) (USD(C)) issued a policy memorandum titled "Progress Payments Distribution" in August 1998 that directed DoD contracting and contract administration offices to provide progress payment distribution information to payment offices, for all new contracts, other than firm-fixed-price contracts, on the basis of the best estimates of the specific work being performed under the contract using available information." This clarification is needed to clarify that the memorandum was directed at contracting and contract administration offices, not disbursing offices; because the existing sentence suggests incorrectly that contracting offices are involved in actual distribution of progress payments; and because the existing sentence could be read to mean that the policy applies to making the payments, when in fact it applies to accounting for the payments.

Deleted

DCMA Comments on Background.

Implementation of Revised Policy. This section should be revised to explain that the USD(C) policy of August 31, 1998 was directed to the Director, Defense Procurement (DDP), and that DDP issued an August 12, 1998 memorandum to procurement organizations, implementing the new policy. This section should also explain that the DDP policy stated that it should not be necessary to require contractors to provide any additional information to support this requirement. This would clarify that the DCMA policy against requiring contractors for a breakdown of costs at the ACRN level was based on DDP policy, and also on USD(C) policy, which required "estimates of the specific work being performed under the contract, using available information." (Emphasis ours).

Revised

FINDING A: Implementation of Payment Instruction Requirements. The progress payment policy originally established by the Under Secretary of Defense (Comptroller) in August 1998 and DFARS 204.7107 (e)(3) were not adequately implemented for 82 of 190 contracts (valued at \$5.9 billion) issued between October 1, 1998, and August 31, 2000. Specifically, for six of the nine contracts that met the Comptroller criteria for payment instructions, DCMA ACOs did not provide payment instructions to DFAS. In addition, for 76 of 138 contracts that met the DFARS criteria for payment instructions, contracting officers did not include the required instructions. These conditions occurred because:

- ACOs did not comply with the DCMA One Book or did not adequately monitor progress payment disbursements by DFAS, and

SUBJECT: DoDIG Draft Report, Project No. D2000FJ-0261,
Revised DoD Progress Payment Practices

- PCOs were either unaware of the DFARS policy or did not believe that it applied to all disbursements for progress payments.

As a result, for the 6 fixed-price (other than firm-fixed-price) and 76 firm-fixed price contracts with estimated total progress payments of \$915.6 million, progress payments will not be distributed to appropriations based on the best estimates of the specific work being performed under the contract using available information.

DCMA COMMENTS:

Partially concur, as explained below. Our comments are directed at the finding pertaining to the progress payment policy established by the USD(C) in August 1998, and at the nine contracts reviewed by the DoD IG.

This finding combines reviews of two distinct, though similar, policies, each applying to different segments of the acquisition community. The first policy is that established by the USD(C) and which is directed at Administrative Contracting Officers (ACOs) and the Defense Contract Management Agency (DCMA). This policy applies to nine fixed-price (other than firm-fixed-price) contracts reviewed by the DoD IG, six of which were found to have non-compliances. The second policy is that prescribed in DFARS 204.7107(e)(3), issued in 1995, and which is directed at Procuring Contracting Officers (PCOs) and their respective buying activities. This policy applies to 138 contracts reviewed by the DoD IG, which were subject to the DFARS requirement, 76 of which were found to have non-compliances.

These two policies are discussed jointly in the introductory segments of Finding A, potentially creating misunderstanding over the nature and magnitude of the respective policies, and the responsibility for their application. The discussion of the finding should be revised to completely separate the discussion of the two policies.

Progress Payment Disbursement Practices

Revised Progress Practices. This paragraph should be revised to cite the Director, Defense Procurement (DDP) policy memorandum of August 12, 1998, which implemented the USD(C) August 7, 1998 policy memorandum. The DDP policy provided more detailed guidance to contracting officers, and in particular advised that, with regard to arriving at a best estimate of how appropriations are used to perform the contract, "...it should not be necessary to require contractors to provide any additional information to support this requirement." This provision was included to avoid shifting to contractors the burden for implementing the USD (C) policy, and was incorporated into DCMA One Book guidance.

Providing Payment Instructions to DFAS

Following DCMA Policy. The draft report states that DCMA's One Book, Chapter 9, requires ACOs to provide instructions to DFAS even when they determined that proration is the best method. In fact, this is partially correct. Although Chapter 9.2, Progress Payments, requires that written distribution instructions be provided to DFAS when the policy applies, the Progress

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Payment Distribution Instructions/Conventions matrix, which is an attachment to the chapter, states as follows, with regard to using the proration method: "When using the Progress Payment Special Instructions field in MOCAS, Proration will be indicated by leaving the field blank (This will allow for the system to automatically pay and prorate the payment)." It appears that there is an ambiguity in the chapter with regard to providing payment instructions to use the proration method. The chapter will be revised to specify that the ACO will document the file to record the determination as to which progress payment distribution method is appropriate. The body of the chapter will be further revised to conform to the matrix, that is, to state that when proration is determined to be the appropriate distribution method, the Progress Payment Special Instructions field will be left blank. This approach permits automatic processing, which is preferable to manual processing of progress payment because it applies certain validations and internal controls, and automatic processing reduces the likelihood of payment-related error.

The draft report also states that five of six ACOs responsible for the nine sample contracts were aware of the DCMA One Book Requirements, and that three ACOs stated that proration may have been valid for the six contracts, but that they did not provide DFAS with instructions to prorate. The chapter clarifications discussed above, and a training package which is in development, will provide ACOs with the necessary information to determine when payment instructions are required, and the appropriate method for developing them and providing them to DFAS.

Monitoring DFAS Payments. The draft report states that ACOs were not always monitoring whether DFAS properly paid progress payments in accordance with the payment instructions provided. It further stated that of three ACOs who provided instructions, only one contacted DFAS to question the payments and make corrections. The report states that additional guidance is needed because the One Book does not specifically require ACOs to monitor whether DFAS follows their progress payment instructions. The IG supports this position by asserting that a process for ACOs to monitor whether DFAS pays according to instructions would ensure that DFAS is aware of contracts that include instructions and that the instructions are followed.

Although we agree that DFAS should pay according to the payment instructions, and although ACOs work with DFAS to improve the payment process, we do not concur that DCMA policy should require ACOs to provide this oversight. DCMA ACOs will continue to work with DFAS to ensure payment accuracy; however, responsibility for ensuring proper application of payment instructions lies with the payment office.

Matching Costs and Progress Payments

Matching Appropriations and Contractor Performance. The draft audit report cites an example in which progress payments did not match the work performed by the contractor. Two delivery orders under contract F33657-99-D-0028 were placed that were valued at \$40.4 million and were intended for labor needed for product support. The contractor was paid \$3.5 million in six progress payments that were funded by multiple appropriations. The IG found that payment instructions were not written for this contract, although they were required as a result of the revised progress payment policy memorandums and the DCMA One Book requirements. Subsequently, DCMA review of these delivery orders confirmed the DoD IG finding and

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determined that in fact, payment instructions were appropriate for these delivery orders. The ACO is in the process of preparing appropriate instructions, based on information in the contract and information that the contractor is required by the contract to provide. Those instructions will be provided to the payment office, and will be updated as appropriate, in accordance with DCMA One Book policy.

Internal Management Control Weakness. We nonconcur that this finding represents an internal management control weakness. DCMA has management controls in place, contained in the policy in One Book Chapter 9.2, Progress Payments, to provide necessary guidance to ACOs regarding the application of progress payment distribution procedures, including the preparation of payment instructions. Furthermore, the policy is reinforced by Internal Operations Assessments (IOAs), which are periodic reviews of DCMA Contract Management Office operations, to ensure that One Book policies are applied. The IOA guidelist for the Progress Payments chapter includes six questions specifically focused on progress payment distribution. These questions have been designated special emphasis items for IOA reviews.

The audit found a total of nine contracts to which the policy applies. Five of the six ACOs for those contracts were aware of the policy. As stated above, in the discussion under "Following DCMA Policy," we will make clarifications in the Progress Payments chapter to remove an ambiguity concerning instructions when proration is appropriate, and to address documenting the file. We are also developing a Progress Payment Distribution training package that will train ACOs as to when instructions are required, how the instructions are to be developed, and how the instructions are to be communicated to DFAS.

Office of Management and Budget circular A-123, "Management of Accountability and Control," states in Section II., Establishing Management Controls, that to help ensure that controls are appropriate and cost-effective, agencies should consider the extent and cost of controls relative to the importance and risk associated with a given program. DCMA recognizes the importance of progress payment distribution and has developed cost-effective management controls for application of this policy. Given the limited number of contracts to which progress payment distribution applies, the existing controls, enhanced as described above, will be adequate for administration of progress payment distribution.

Adequacy of Management's Self-Evaluation. The draft report asserts that management's self-evaluation was not adequate, because DCMA identified contract payments as assessable units; however, DCMA did not report the material management control weaknesses identified during the audit. We nonconcur that the DCMA self-evaluation was not adequate. DCMA has policies in place to manage preparation of instructions for progress payment distribution, and for monitoring the input of instructions into MOCAS. We have procedures in place to apply those policies, and we have oversight in place, through our IOA process. Therefore, the management self-evaluation was adequate.

Internal Management Control Weakness:
 Nonconcur.
 Concur.

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Recommendation A.2: We recommend that the Director, Defense Contract Management Agency:

- a. Direct administrative contracting officers to provide payment instructions to the Defense Finance and Accounting Service on all contracts meeting the requirements of the revised Comptroller progress payment policy.
- b. Initiate action to develop payment instructions for the 76 firm-fixed-price contracts identified by the audit shown in Appendix B.
- c. Revise Defense Contract Management Agency Directive 1, the One Book, to include a requirement that administrative contracting officers monitor whether the Defense Finance and Accounting Service pays progress payments according to the payment instructions provided.
- d. Establish a tracking system and performance metric that maintains updated information on all contracts that may require payment instructions, shows how many contracts include payment instructions, and shows whether the Defense Finance and Accounting Service makes payments according to the instructions.

DCMA COMMENTS:

Recommendation A.2.a.

Partially concur. DCMA will direct ACOs responsible for administration of the contracts subject to the revised DoD Comptroller progress payments policy to ensure that progress payment distribution instructions are provided to the Defense Finance and Accounting Service, in accordance with the guidance contained in DCMA One Book Chapter 9.2, Progress Payments, for those contracts. As explained above, the One Book will be revised to clarify that if the ACO determines that the appropriate progress payment distribution method is proration, the MOCAS "Progress Payment Special Pay Instructions" field will be left blank, but the file will be documented accordingly.

Recommendation A.2.b.

Concur. DCMA will initiate action to develop payment instructions for the 76 firm-fixed-price contracts identified by the audit shown in Appendix B by instructing ACOs to advise the PCOs that the PCOs must provide payment instructions in accordance with DFARS 204.7107 (e)(3). This applies to those contracts for which PCOs are required to develop payment instructions for the contract line items funded by multiple accounting classifications, in accordance with Defense Acquisition Supplement 204.7107 (e)(3).

Recommendation A.2.c.

Nonconcur. Although providing payment instructions for the progress payment distribution policy is an ACO responsibility, it is the responsibility of DFAS to apply those instructions when making payments. It would be inappropriate for DCMA to build into its management controls a process for the oversight of DFAS performance with regard to following payment instructions.

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Recommendation A.2.d.

Nonconcur. DCMA uses performance goals, in accordance with direction in the Government Performance and Results Act, to establish the Agency's near-term (annual) strategy for measuring its progress in achieving the long-range (strategic) objectives. It would be inappropriate to establish a tracking system and performance metric addressing the preparation of payment instructions and the application of payment instructions for the following reasons:

- 1) The number of contracts covered by the USD (C) revised progress payment policy is very small. The DoD IG identified only nine contracts as subject to that policy. Of those, three contracts have since been converted to Performance-Based Payments, and are no longer subject to the revised progress payment policy. Establishing a tracking system and metric to monitor such a small number of contracts would not accomplish a strategic DCMA objective.
- 2) PCOs are responsible for developing payment instructions under the policy contained in DFARS 204.7107(e)(3). Monitoring how well the buying activities are complying with DFARS requirements is the responsibility of the buying activities and would not be an appropriate function for DCMA.
- 3) DFAS is responsible for making payments in accordance with the appropriate DoD guidance, and with payment instructions provided in the contract and by the ACO. Monitoring the degree to which DFAS pays according to payment instructions is the responsibility of DFAS, and would not be an appropriate function for DCMA.
- 4) OMB Circular A-123, Management Accountability and Control, states that Federal managers are responsible for implementing management controls that are cost effective. Requiring DCMA to implement controls that are duplicative of controls that are (or should be) implemented at other Defense Components is not cost effective.

Disposition:

(x) Action is ongoing. Estimated Completion Date: January 31, 2002
() Action is considered complete.

FINDING B: Following Progress Payment Instructions.

For the three fixed-price (other than firm-fixed-price) and four firm-fixed-price contracts that contained payment instructions, DFAS did not always properly follow the payment instructions provided by the contracting officers. DFAS did not pay according to payment instructions for the seven contracts because the instructions were either not properly entered into MOCAS, not verified by the ACO, not followed, or MOCAS controls were not adequate. As a result, approximately \$39.7 million in progress payment disbursements related to the seven contracts were either inappropriately prorated from multiple appropriations or paid using a different payment methodology from those specifically directed by contracting officers.

DCMA COMMENTS:

Partially concur. We concur that payments were not made according to instructions because payment instructions were either not properly input into MOCAS or were not followed by the payment office. However, as explained below, we do not concur that the lack of verification by

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the ACO that the payment instructions were input correctly is a direct cause of incorrect payment, nor do we concur that MOCAS controls are inadequate.

Payment Instructions and MOCAS Controls

ACO Verification. Although we recognize that ACOs are to verify that instructions have been input correctly, the primary responsibility for inputting the instructions resides with DFAS. The ACO's role in this function is essentially a secondary role, and as such, is only an indirect contributor to the finding that the payment office did not properly follow payment instructions. DCMA is developing training that will reinforce the guidance already in the One Book that ACOs are to verify that payment instructions have been entered into MOCAS. The training will also address how the payment instructions are to be entered.

MOCAS Controls. The draft report asserts that controls over progress payments with written payment instructions that were properly input into MOCAS were not adequate. We nonconcur that MOCAS controls are inadequate. An example in the report cited a situation where instructions were put into the ACO Notebook, and DFAS failed to check that field before MOCAS made the payment. The intended field for progress payment instructions is the Progress Payment Special Pay Instructions. When this field is used, MOCAS will not make the payment automatically. Furthermore, instructions in this field will be readily visible to the DFAS payment specialist during the payment process. The ACO Notebook was not intended to convey payment instructions. Therefore, the situation cited in the draft report could have been avoided if the Progress Payment Special Pay Instructions field were used.

Another situation cited by the draft report involved payments where payment instructions were not followed, although at the time of the DoD IG audit, instructions were present in the Progress Payment Special Pay Instructions field. The DoD IG could not determine whether the payment instructions were input before or after the two progress payments were inappropriately made because the date that the field was coded was not available. Our experience has been that the controls built into the Progress Payment Special Pay Instructions field are effective in preventing automatic payment. In the event that evidence develops that there is a malfunction in this field, we will investigate the cause of the problem.

Prorating Progress Payments. The draft report asserts that MOCAS did not alert payment personnel that payment instructions were present even though the payment instructions were entered into MOCAS properly. As explained above, the Progress Payment Special Pay Instructions field is the appropriate field for entering progress payment instructions. Furthermore, we do not believe the situations described in the report indicate conclusively that MOCAS controls are not functioning properly. We do believe that the report identified circumstances that can be avoided with additional training, and with minor modifications to the One Book. DCMA will incorporate into the training package discussed above instructions on the proper use of the Progress Payment Special Pay Instructions field.

Internal Management Control Weakness. We nonconcur that this finding represents a material internal management control weakness for DCMA. As explained above, DFAS has responsibility for paying according to payment instructions contained in the contract. DFAS also

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has primary responsibility for entering payment instructions into MOCAS, when those payment instructions are included under the requirements of DFARS 204.7107(e)(3).

The DCMA One Book does require that ACOs verify that the instructions which are input by DFAS are input correctly, and for verifying that instructions which ACOs prepare are entered into MOCAS properly. DCMA will provide training to ACOs on the process for entering payment instructions and for verifying that payment instructions entered by DFAS are entered properly. This training will avoid the occurrence of problems cited in the report for which DCMA is cognizant.

Adequacy of Management's Self-Evaluation. The draft report asserts that management's self-evaluation was not adequate, because DCMA identified contract payments as assessable units; however, DCMA did not report the material management control weaknesses identified during the audit. We nonconcur that the DCMA self-evaluation was not adequate. DCMA has policies in place to manage preparation of instructions for progress payment distribution, and for monitoring the input of instructions into MOCAS. We have procedures in place to apply those policies, and we have oversight in place, through our IOA process. Therefore, the management self-evaluation was adequate.

Internal Management Control Weakness:
 Nonconcur.
 Concur.

Recommendation B.1: We recommend that the Director, Defense Contract Management Agency:

- a. Identify all progress payment contracts that include payment instructions to the Defense Finance and Accounting Service Columbus.
- b. Direct administrative contracting officers to follow Defense Contract Management Agency "One Book" policy and verify the accuracy of instructions and that the "Progress Payment Special Pay Instructions" field in Mechanization of Contract Administration Services is properly coded, when instructions are present.
- c. Direct responsible administrative contracting officers to coordinate with the Defense Finance and Accounting Service Columbus to review progress payments made for instances in which payment instructions were not followed and make the necessary corrections for the following seven contracts: F0470100C0500, F0470199C0047, F1962800C0023, F3365799C3045, F3365799G39000004, F3365799G39000024, and N0003099C0008.

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DCMA COMMENTS:

Recommendation B.1.a. Nonconcur. The primary responsibility for identifying contracts with payment instructions, and for inputting the instructions into MOCAS, resides with DFAS. The ACO's role in this function is essentially a secondary role, as explained above. DCMA will remind ACOs of the One Book requirements to verify that the payment instructions have been entered into MOCAS. The training package discussed above, which is in development, will also reinforce the One Book requirement.

Recommendation B.2.b. Concur. DCMA will direct ACOs to follow DCMA "One Book" policy and verify the accuracy of instructions, and will direct that ACOs properly code the "Progress Payment Special Pay Instructions" field in MOCAS when instructions are present.

Recommendation B.2.c. Concur. DCMA will direct responsible ACOs to coordinate with the Defense Finance and Accounting Service Columbus to review balances of progress payments made for instances in which payment instructions were not followed and make the necessary corrections for the following seven contracts: F0470100C0500, F0470199C0047, F1962800C0023, F3365799C3045, F3365799G39000004, F3365799G39000024, and N0003099C0008. This recommendation will be implemented by ensuring that distribution of current balances of unliquidated progress payments are in accordance with policy contained in the One Book.

Disposition:

- () Action is ongoing. ECD: January 31, 2002
- () Action is considered complete.

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